

# Joint Economic Committee WEEKLY ECONOMIC DIGEST

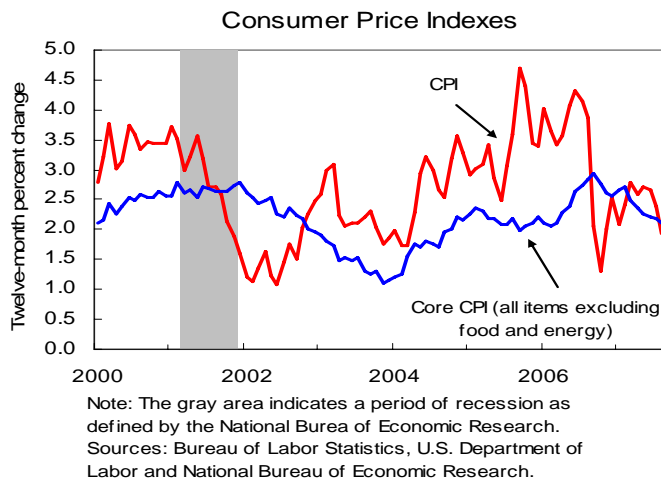
Senator Charles Schumer, Chairman  
Congresswoman Carolyn Maloney, Vice Chair

September 24, 2007

## ECONOMIC NEWS

### Inflation Remained Tame As New Homebuilding Weakened Further in August

**Declining energy prices curbed overall inflation in consumer prices in August.** The consumer price index (CPI) declined by 0.1 percent last month, following a 0.2 percent rise in July. The price of energy to consumers dropped by 3.2 percent in August, after declining by 1.0 percent in July, and 0.5 percent in June. Core CPI inflation (which excludes changes in the volatile prices of food and energy) remained at 0.2 percent in August. Over the past 12 months, the overall CPI has risen by 1.9 percent, and the core CPI by 2.1 percent (see chart).



**New homebuilding dropped further last month.** New construction of privately owned housing fell by 2.6 percent in August to 1.331 million units at an annual rate. New construction of single-family homes fell by 7.1 percent to 998,000 units, following a 7.3 percent drop in July. New construction of single-family homes is currently at its lowest level in more than 12 years. Moreover, permits to build new single-family homes dropped by 8.1 percent last month, to 926,000 units at an annual rate. Permits for new residential construction have fallen by 24.5 percent over the past 12 months, reflecting ongoing pessimism among homebuilders as to the near-term prospects for home building.

**Housing-related wealth declined in the second quarter.** Owner's equity in household real estate (the market value of owner-occupied housing less mortgage debt outstanding) dropped by 0.1 percent in the second quarter, according to data released last week by the Federal Reserve. Over the past four quarters, housing-related wealth has risen by only 0.9 percent, the slowest four-quarter pace since early 1993.

## IN FOCUS

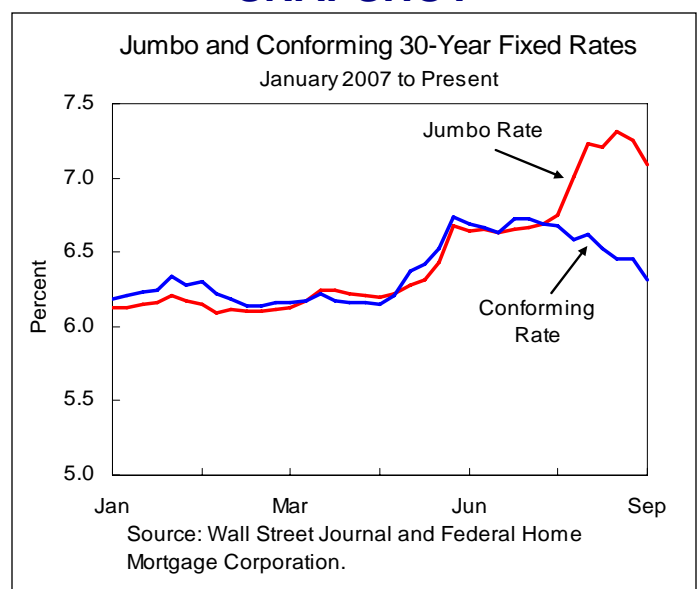
### The Fed's Concern

Last week, the Federal Open Market Committee (FOMC) cut its target for the interest rate on the overnight federal funds rate by  $\frac{1}{2}$  percentage point to  $4\frac{3}{4}$  percent, the largest cut since November 2002. The FOMC cast its decision as a preemptive move, intended "to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets." The FOMC's chief concern is avoiding a contagion spreading from the deteriorating home finance market to other financial markets. Financial market contagion, which occurs when problems in one market segment make participants in other segments significantly more risk averse, can raise the cost of credit, or cause it to dry up.

Home finance has changed dramatically in the last 20 years. While securitization of loans by Fannie Mae and Freddie Mac has traditionally worked to increase credit available to prime lenders, the securitization of subprime loans is a more recent development. Until fairly recently, borrowers with lower credit worthiness relied upon the Federal Housing Authority to insure their mortgages. Beginning in the mid-1990's, non-agency lenders began to expand their lending to subprime borrowers, funding their lending through the capital markets. Subprime lending expanded very rapidly after 2001, since securities backed by high-yield, high-risk subprime mortgages were in de-

*Continued on reverse...*

## SNAPSHOT



# Joint Economic Committee WEEKLY ECONOMIC DIGEST

## THE WEEK AHEAD

DAY	RELEASE
Tuesday, Sep 25	Existing Home Sales (August 2007)
Wednesday, Sep 26	Advance Report on Durable Goods Manufacturers' Shipments, Inventories and Orders (August 2007)
Thursday, Sep 27	Gross Domestic Product and Corporate Profits (Second Quarter 2007, Final) New Residential Sales (August 2007)
Friday, Sep 28	Personal Income and Outlays (August 2007) Construction Spending (August 2007)

*Wednesday,  
Sep 26th:  
Capital  
spending  
indicators*

## THE ECONOMY AT A GLANCE

KEY INDICATORS	MONTH			QUARTER			YEAR	
	Aug	Jul	Jun	2007 Q2	2007 Q1	2006 Q4	2006	2005
Real GDP Growth (%)	—	—	—	4.0	0.6	2.1	2.9	3.1
Unemployment (% of labor force)	4.6	4.6	4.5	4.5	4.5	4.5	4.6	5.1
Labor Productivity Growth (%)	—	—	—	2.6	0.7	1.8	1.0	1.9
Labor Compensation Growth (%)	—	—	—	3.6	3.2	3.6	3.1	3.3
CPI-U Inflation (%)	-1.2	1.2	2.4	6.0	3.8	-2.1	3.2	3.4
Core CPI-U Inflation (%)	2.4	2.4	2.4	1.9	2.3	1.9	2.5	2.2

Sources: Bureau of Economic Analysis, U.S. Department of Commerce; Bureau of Labor Statistics, Department of Labor.

Notes: Except where otherwise noted, values in the table represent percent changes at seasonally adjusted annual rates. Productivity is output per hour worked in private nonfarm businesses. The Employment Cost Index is for civilian workers in government and business. Core CPI-U inflation is the percent change in the CPI-U excluding food and energy as reported by the Bureau of Labor Statistics. The designation "n.a." denotes that data are not yet available.

## IN FOCUS (Continued)

mand. These mortgage-backed securities (MBS) often became the assets underlying collateralized debt obligations (CDOs). The proliferation of MBS and CDO securities brought benefits as well as costs. Chief among the benefits was that MBS and CDO securities dispersed the risks of their constituent subprime loans across a broad segment of investors. However, the costs of those financial market developments have become more evident recently: once the default and foreclosures rates on subprimes increased, the effects spread rapidly across financial markets.

In August, when the value of subprime mortgages appeared lower than originally estimated, large volumes of MBS and CDO securities were affected. Uncertainty about the size and location of subprime losses related to CDOs caused the market for commercial paper (unsecuritized corporate debt, used primarily to maintain short term liquidity) to seize. Some subprime mortgage lenders saw their credit evaporate just when they were dealing with rising losses, and several failed. Trade in non-agency MBS fell dramatically. On August 17, the Federal Reserve helped somewhat by lowering its discount rate and extending the term length of loans from its discount window.

Mortgage problems have expanded beyond the subprime market. Mortgages above a certain amount (currently \$417,000)—termed “jumbo” loans—must be securitized by private firms as they exceed the government-sponsored entities (GSEs) conforming loan limits. The spread between prime and jumbo loans increased from its traditional 25-35 basis point spread to over 80 basis points (see SNAPSHOT). This jump in interest rates for jumbo loans may not reflect an increase in the risk of default for such loans, but may indicate a drop in demand for mortgage-backed securities that are not guaranteed by the GSEs.

The increased securitization of home finance has complicated monetary policy. As Chairman Bernanke noted in his speech at Jackson Hole at the end of last month, this increase in securitization appears to have reduced the sensitivity of housing to changes in the short-term interest rate. Ongoing uncertainty in financial markets warranted significant preemptive response by the Fed last week, but it leaves open the question of whether more is needed.